



**TAX PERSPECTIVE - WHICH FORM OF  
ENTITY IS RIGHT FOR YOUR STARTUP  
BUSINESS?**



# TAX TOPICS WE WILL COVER

Sole Proprietorships, Partnerships and LLCs

Mitch Gibson

Corporation: S, C and QSB

Rebecka Haynes

Exit Strategies: Selling a Successful Small Business

Ken Silverberg

Questions and (WE HOPE!) Answers

ALL

# **NON-CORPORATE PASS-THROUGH ENTITIES**

**Mitch Gibson**

# NON-CORPORATE BUSINESS ENTITIES



## WHAT NON-CORPORATE BUSINESS ENTITY CAN YOU PICK?

A sole proprietorship is the simplest pass-through entity. It is owned by a single person and operated in their personal capacity.

A partnership is a business owned by at least two people and operated in their personal capacity.

Sole proprietorships and partnerships do not need to be registered with the State Corporation Commission.

## WHAT NON-CORPORATE BUSINESS ENTITY CAN YOU PICK?

A limited liability company (LLC) is a statutorily authorized company that limits liability for its members and managers.

An LLC can be managed by its members or by a manager.

LLCs must be registered with the State Corporation Commission.

## HOW TO FORM A SOLE PROPRIETORSHIP OR PARTNERSHIP?

Start doing business! Sole proprietorships and partnerships do not require any authorization from the state to be created.

Some businesses will require licenses, permits, registering business, or zoning clearance. It is important to check that you are compliance with these laws before starting the business.

If the business will have employees other than the employer, you should obtain an Employer Identification Number (EIN) from the IRS.

# PARTICULAR ISSUES WITH PARTNERSHIPS

Having a partnership agreement in place before starting the business is always a good idea.

Determine how gains and losses will be divided between the partners. Without an agreement, everything will be split evenly between the partners.

Courts will respect the terms the partnership agreement so long as they were not done solely for tax purposes.



## HOW TO FORM AN LLC

An LLC must complete Form LLC-1011 and file it with the State Corporation Commission. Certain professions (e.g., doctors, architects, lawyers) should complete Form LLC-1103 to become a Professional Limited Liability Company.

The business must obtain an Employer Identification Number (EIN) from the IRS.

# WHAT IS PASS-THROUGH TAXATION?

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**Pass-through taxation does not tax the business entity. Instead, all gains and losses are taxed at the owner level.**

**Pass-through taxation can be used by all business entities except C corporations.**

# ADVANTAGES AND DISADVANTAGES COMPARED TO C CORPORATIONS

## Advantages of Pass Through

- Single Level of Tax
- Pass-Through Losses
  - There are limits on how much losses can be attributed to members of an LLC and limited partners
- Qualified Business Deduction

## Disadvantages of Pass Through

- Liquidity (“phantom income”)
- Tax consequences may dissuade investors
- Deduction of State and Local taxes limited to \$10,000 per member/partner
- Potential self-employment tax

# CORPORATIONS

Rebecka Haynes

# CAN CORPORATIONS HAVE PASS- THROUGH TAXATION?

# CAN CORPORATIONS HAVE PASS-THROUGH TAXATION?

**YES!**

**A Corporation May Elect to be Taxed as an S Corporation and be Treated as a Pass-Through Entity for Tax Purposes.**

# S CORPORATIONS





# WHAT IS AN S CORPORATION (S CORP) ?

An S Corp is not an actual entity type, rather it is a corporation that elects to be taxed under Subchapter S of the tax code.

Corporate income, losses, deductions, and credits pass through to shareholders for federal tax purposes.

Shareholders report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates.

# HOW TO FORM AN S CORPORATION?

1. Incorporate in the state of your choice
2. Ensure the corporation meets the requirements to become an S Corp (listed in the next slide).
3. Submit Form 2553 Election by a Small Business Corporation within the applicable deadline and signed by all the shareholders.

# REQUIREMENTS TO BECOME AND REMAIN AN S CORP

Be a domestic corporation

Have only allowable shareholders

- Individuals, certain trusts, and estates and
- **NO partnerships, corporations or non-resident alien shareholders**

Have no more than 100 shareholders

Have only one class of stock

Not be an ineligible corporation

- i.e., certain financial institutions, insurance companies, and domestic international sales corporations

# WHY AN S-CORP OVER OTHER PASS-THROUGH ENTITIES?

## HOW AN S-CORP IS SIMILAR TO OTHER PASS-THROUGH ENTITIES

- Single Level of Tax
- Pass-Through Losses
  - Limited by shareholder's basis, at-risk rules and passive activity loss rules
- Qualified Business Deduction

## HOW AN S-CORP IS DIFFERENT

- Tax-free reorganization
- Provision of Stock Options
- Easy conversion to C-Corp status
- Strict Formation Requirements

# C CORPORATIONS



# WHAT IS A C CORP?

i.e. a regular corporation

- A separate entity distinct from its owners – taxed separately

A corporation may be formed only through compliance with a state incorporation statute.

A corporation can be closely held (i.e., have only one or a small number of shareholders) or it can be publicly held (i.e., have a large number of owners with the shares sold on a public market).

State Law: Some states also have separate provisions for the organization of closely held corporations, which enabling owners to dispense with some of the corporate formalities that are inherent in managing a corporation.

# DOUBLE TAXATION

Flat 21% tax rate

20% maximum tax rate on dividends paid to shareholders

If the corporation distributes earnings to shareholders, those earnings are taxed twice—once at the corporate level and again as individual earnings.

Effective tax rate of 41% on distributions.

# QUALIFIED SMALL BUSINESS STOCK

Qualified Small Business Stock held for more than five (5) years after issuance is eligible for 100% exclusion from gain on disposition, not to exceed for any one shareholder, \$10 million (or if greater, 10x the taxpayer's basis in the stock)

## Qualified Small Business Stock is stock:

- Issued by a C corporation at original issuance;
- The C Corp is engaged in an active business (at least 80% of its assets used in) that is not a type of services business (e.g., law, engineering, banking, investing, farming, architecture, hotels, restaurants, etc.)
- Gross assets (including those received for the issuance) do not exceed \$50M



## C - CORP

- Double Taxation
- Retention of Operating Capital
- Can issue more than 1 class of stock
- § 1202 Exclusion for Gain from Certain Small Business Stock
- Unlimited Deduction of State and Local Taxes

## S – CORP

- Single Level of Tax
- Pass-Through Losses
  - Limited by shareholder's basis, at-risk rules and passive activity loss rules
- Qualified Business Deduction
- Strict Requirements
  - Limits on Provision of Stock Options
  - Limits the availability of VC funding and foreign investment
- Deduction limited to 10K per shareholder

# EMPLOYMENT TAXES CONSIDERATIONS

## Employment Taxes

- An employer must file Form W-2 to report wages, tips and other compensation paid to an employee.
- Employers generally must withhold federal income tax, part of social security, and Medicare taxes from employees' wages.
- Federal Unemployment (FUTA) Tax – paid by the employer; separate from federal income, social security and Medicare taxes. [this is not withheld from employee wages].

## Self Employment Taxes

- The LLC does not pay taxes at the entity level – thus also does not pay Social Security and Medicare taxes
- Members must pay a self-employment tax on their individual tax return if they are an employee of the business; this tax is in addition to the tax of the members' individual share of the company income.

## Reasonable Compensation

- S corporations must pay reasonable compensation to a shareholder-employee before non-wage distributions may be made to the shareholder-employee.

# **SALE OF A SUCCESSFUL SMALL BUSINESS**

## **MITCH'S LANDSCAPING SERVICE**

### **Terms of Offer to Purchase**

**Ken Silverberg**



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OF INTELLECTUAL PROPERTY  
GEORGE MASON UNIVERSITY  
ANTONIN SCALIA LAW SCHOOL

## •WHAT DOES THE BUYER OF A SERVICE BUSINESS ACTUALLY BUY?

Mitch's Landscaping collections	
2016	219,000
2017	175,000
2018	195,000
2019	225,000
2020	310,000

- **Purchase price is usually based on the revenue of the business, not the hard assets.**

## •OFFER TO PURCHASE MITCH'S LANDSCAPING SERVICE

- Purchaser offers 3 times the average annual collections of the business over the past five years.

		<b>collections</b>
buyer offers to pay 3x the average collections for the past 5 years	2016	219,000
	2017	175,000
	2018	195,000
	2019	225,000
	2020	<u>310,000</u>
	total	1,124,000
	÷ 5 =	224,800
offer price =	x 3 =	<b>\$ 674,400</b>

## • COVENANT NOT-TO-COMPETE

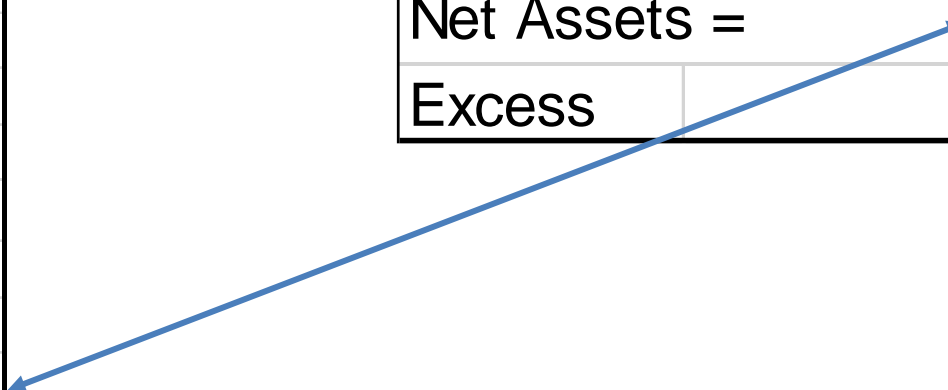
- **As a condition of the purchase, Mitch must agree not to solicit business from his former customers or from anyone else in the same zip code for three years. He will be paid an additional \$50,000 per year for this promise.**

purchase of business		674,400
non-compete		<u>150,000</u>
total		824,400

• WHY WOULD SOMEONE PAY \$674,000 FOR \$460,000 WORTH OF ASSETS?

Mitch's Landscaping Balance Sheet		
<b>Assets</b>		
cash		120,000
customer A/R		300,000
equipment		
cost	270,000	
depreciation	<u>180,000</u>	
net	90,000	<u>90,000</u>
Total Assets		510,000
<b>Liabilities</b>		
vendor A/P		20,000
payroll taxes		<u>30,000</u>
Total Liabilities		50,000
<b>Net Assets</b>		<b>460,000</b>

Purchase Price =	674,400
Net Assets =	<u>460,000</u>
Excess	214,400



# INTANGIBLE ASSETS

- Customer lists
- Intellectual property (patents, trademarks, copyrights, trade names, logos, etc.)
- Web sites, domain names, etc.
- Goodwill (everything else)



• IRS REQUIRES BUYER AND SELLER TO AGREE ON ALLOCATION

Mitch's Landscaping Balance Sheet		
<b>Assets</b>		
cash		120,000
customer A/R		300,000
equipment		
cost	270,000	
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Total Assets		510,000
<b>Liabilities</b>		
vendor A/P		20,000
payroll taxes		<u>30,000</u>
Total Liabilities		50,000
<b>Net Assets</b>		<b>460,000</b>

Mitch's Landscaping FMV Purchase Price Allocation	
<b>Assets</b>	<u>total</u>
cash	120,000
customer A/R	300,000
equipment	90,000
goodwill	<u>214,400</u>
Total Assets	724,400
<b>Liabilities</b>	
vendor A/P	20,000
payroll taxes	<u>30,000</u>
Total Liabilities	50,000
Net Assets	674,400
Non compete	<u>150,000</u>
<b>Total to Mitch</b>	<b>824,400</b>

# FEDERAL INCOME TAX RATES DEPEND ON WHAT IS SOLD AND BY WHOM

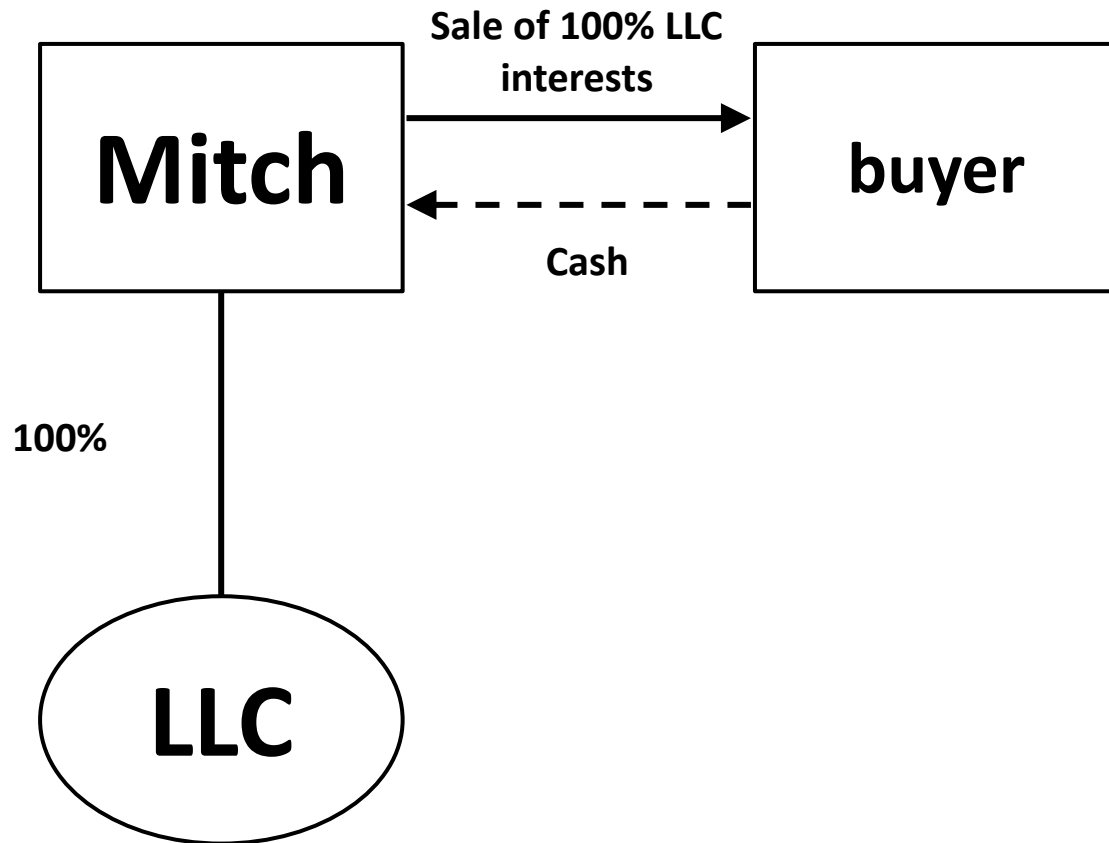
- **Individual Rate: 37%**
- **Corporate Rate: 21%**
- **Capital Gains Rate: 20%**
- **Qualified Dividend Rate: 20%**
- **Net Investment Income: 3.8%**

# Assume Mitch's Landscaping is a Sole Proprietorship, a SMLLC or an S Corp

Mitch's Landscaping			
FMV Purchase Price Allocation			
<u>Assets</u>	<u>total</u>	<u>capital</u>	<u>ordinary</u>
cash	120,000	-	120,000
customer A/R	300,000	-	300,000
equipment	90,000	-	90,000
goodwill	214,400	214,400	-
Total Assets	724,400	214,400	510,000
<b>Liabilities</b>			
vendor A/P	20,000	-	20,000
payroll taxes	30,000	-	30,000
Total Liabilities	50,000	-	50,000
Net Assets	674,400	214,400	460,000
Non compete	150,000	-	150,000
<b>Total to Mitch</b>	<b>824,400</b>	<b>214,400</b>	<b>610,000</b>

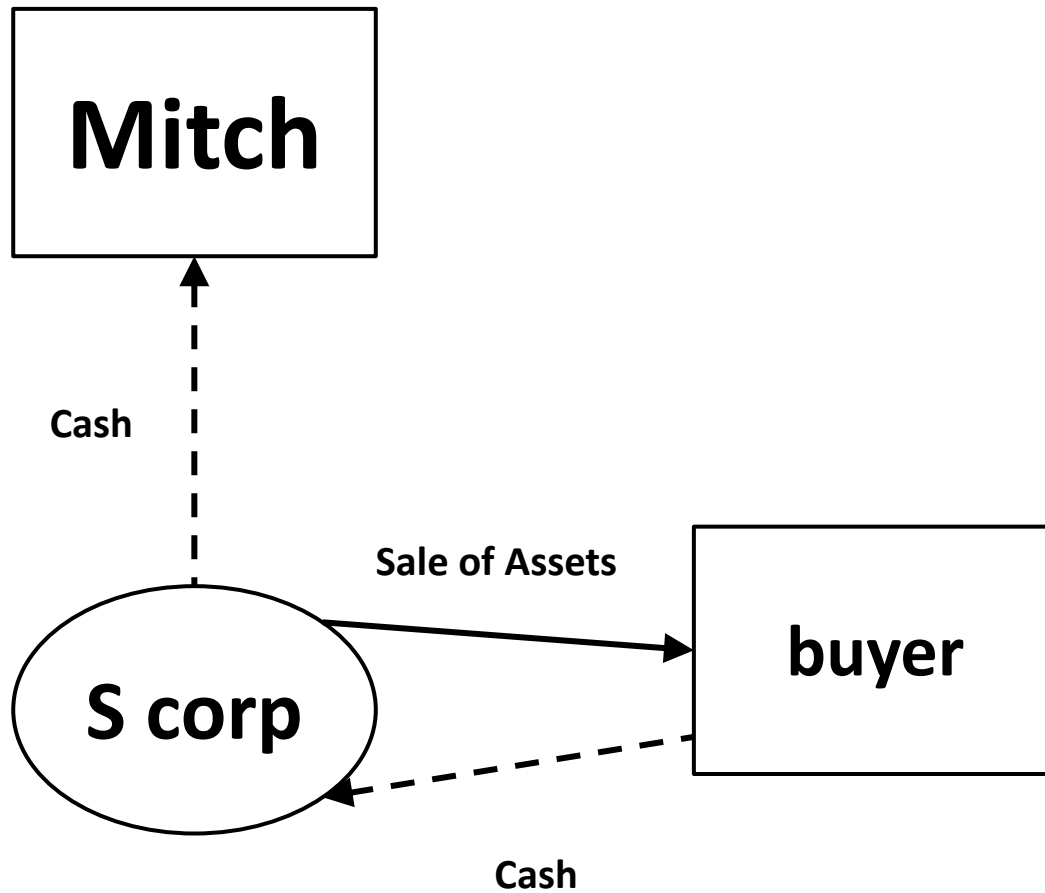
TAX COMPUTATION			
	<u>total</u>	<u>capital</u>	<u>ordinary</u>
Total to Mitch	824,400	214,400	610,000
less tax basis	(assumed = zero)		
tax rate		20%	37%
F.I.T.	268,580	42,880	225,700
<b>AFTER TAX</b>	<b>555,820</b>		

## •SALE OF 100% OF YOUR LLC MEMBERSHIP INTERESTS



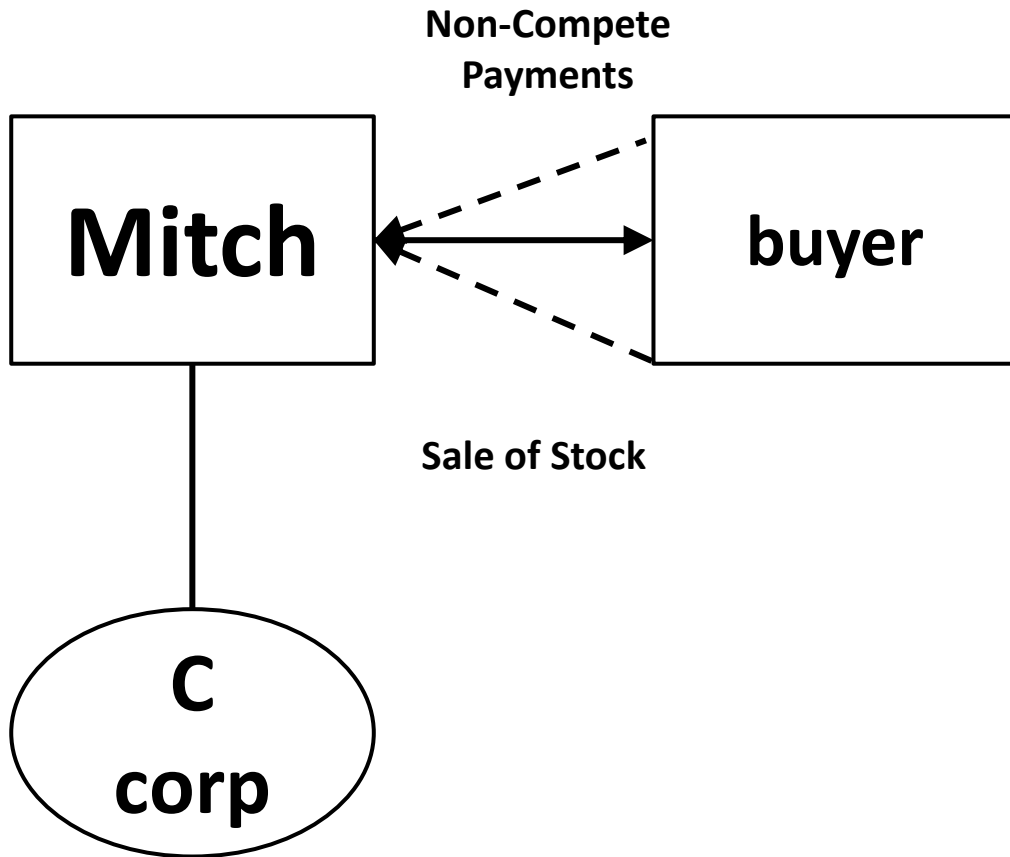
- Single-Member LLC
- Same result as the sale of a sole proprietorship because a SMLLC is treated as a disregarded entity for tax purposes. Therefore, Mitch's sale is treated as a sale of assets.

•SALE BY YOUR S CORP OF 100% OF ITS ASSETS



- S corporation
- Same result as the sale of a sole proprietorship if the S corp sells the assets and distributes the cash because the S corp does not pay tax

•BUT WHAT IF IT'S A C CORP INSTEAD OF AN S CORP?



- Sell Stock if it's a C corporation
- An asset sale by a C corp followed by a distribution to the shareholders normally incurs double taxation.
- Mitch would prefer to sell his stock.
- There will still be a separate tax on the non-compete payments to Mitch.

# Assume Mitch's Landscaping is a C Corp

Tax on Mitch			
	total	capital	ordinary
Sale of stock	674,400	674,400	-
Non-compete	<u>150,000</u>	<u>-</u>	<u>150,000</u>
Total	824,400	674,400	150,000
tax rate		20%	37%
F.I.T.	190,380	134,880	55,500
<b>AFTER TAX</b>	<b>634,020</b>		

# EVEN BETTER!

Assume Mitch's Landscaping is a C Corp AND it is Qualified Small Business Stock

Tax on Mitch			
	total	1202	ordinary
Sale of stock	674,400	674,400	-
Non-compete	<u>150,000</u>	<u>-</u>	<u>150,000</u>
Total	824,400	674,400	150,000
tax rate		0%	37%
F.I.T.	55,500	-	55,500
<b>AFTER TAX</b>	<b>768,900</b>		



## • WHY NOT ALWAYS USE A C CORP AND SELL STOCK?

- Sole proprietorship, SMLLC or S corporation

- After-Tax Cash to Mitch = \$555,820

- C corporation

- After-Tax Cash to Mitch = \$634,020

- C corporation with QSB Stock

- After-Tax Cash to Mitch = \$768,900

- BUYER WANTS TO BUY ASSETS – SELLER WANTS TO SELL STOCK

- BUT ... a sophisticated buyer will pay less for stock because:

- Buyer understands your taxes
- Buyer doesn't get a step-up in basis for future depreciation
- Buyer inherits all liabilities – known or unknown

- SO . . . back to Rebecka's and Mitch's discussion of the non-tax advantages & disadvantages of different forms of business.

# QUESTIONS

## Contact

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